SEC Provides Guidance Relating to the Proxy Voting Process: First Analysis

A Lexis Practice Advisor® Practice Note by
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Introduction

This article discusses two releases published by Securities and Exchange Commission (SEC) on August 21, 2019. One release contains interpretation and guidance regarding the applicability of certain rules (Proxy Voting Advice Guidance) promulgated under Section 14 of the Securities Exchange Act of 1934, as amended (Exchange Act) to proxy voting advice. The other, which technically is a "policy statement," provides guidance on the proxy voting responsibilities of investment advisers (Investment Adviser Guidance) under the Investment Advisers Act of 1940, as amended (Advisers Act). As both sets of guidance will be effective upon publication in the Federal Register, both sets will apply to the 2020 proxy season.

The SEC has been considering issues surrounding the proxy voting process for years. In 2003, the SEC adopted Rule 206(4)-6 under the Advisers Act relating to the proxy voting responsibilities of registered investment advisers (Proxy Voting Rule), and a number of enforcement actions followed. The SEC issued a concept release in 2010 on the U.S. proxy system, often referred to as the "proxy plumbing" release, which, among other topics, addressed the role and legal status of proxy advisory firms and potential regulatory responses. The SEC staff held a roundtable on the use of proxy advisory firms in 2013 and issued Staff Legal Bulletin No. 20 in 2014 providing guidance with respect to the availability and requirements of two federal proxy rule exemptions that proxy advisory firms may seek to rely on. In November 2018, the SEC staff hosted a roundtable on the proxy process, with one of the three panels devoted to a discussion of proxy advisory firms. To facilitate discussion at the roundtable, the staff of the Division of Investment Management withdrew two no-action letters addressing conflicts of interest and registered investment advisers' use of proxy advisory firms, namely Egan-Jones Proxy Services (May 27, 2004) and Institutional Shareholder Services, Inc. (Sept. 15, 2004). The SEC issued the current guidance after considering the viewpoints of various constituencies.

Background

Rule 14a-1(l) under the Exchange Act defines solicitation broadly to include a "communication to security holders under circumstances reasonably calculated to result in the

procurement, withholding or revocation of a proxy." The antifraud prohibitions of Rule 14a-9 apply to solicitations, regardless of whether the solicitations are exempt from the information and filing requirements of the federal proxy rules. The Proxy Voting Advice guidance interprets how these rules apply to voting advice provided by proxy advisory firms.

The Proxy Voting Rule requires registered investment advisers to adopt and implement written policies and procedures that are reasonably designed to ensure that the adviser votes client securities in the best interest of clients (including procedures to address material conflicts that may arise between the adviser's interests and those of its clients; disclose to clients how they may obtain information from the adviser about how the adviser voted with respect to their securities; and describe to clients the adviser's proxy voting policies and procedures and, upon request, furnish a copy of the policies and procedures to the requesting client. In addition, under the Advisers Act all investment advisers are fiduciaries that owe each of their clients duties of care and loyalty with respect to services undertaken on the client's behalf, including proxy voting. The Investment Adviser Guidance provides guidance on the proxy voting responsibilities of investment advisers under the Proxy Voting Rule and the Advisers Act more generally.

Initial Guidance and Next Steps

Proxy Voting Advice Guidance

In the Proxy Voting Advice Guidance, the SEC articulated its view that proxy voting advice "provided by a firm marketing its expertise in researching and analyzing proxy issues for purposes of helping its clients make proxy voting determinations (i.e., not merely performing administrative or ministerial services) should be considered a solicitation subject to the federal proxy rules." According to the Proxy Voting Advice Guidance, this is the case even if the proxy advisory firm makes recommendations based on application of its client's own tailored voting guidelines and even in circumstances where its client may not follow the advice provided.

The SEC distinguished proxy voting advice provided by proxy advisory firms from "unsolicited" voting advice that a broker might give when responding to a customer inquiry because proxy advisory firms are not "merely responding to client inquiries." Rather, "the communication is invited by the proxy advisory firms themselves through the marketing of their expertise in researching and analyzing proxy issues for purposes of helping clients make proxy voting determinations."

Because Rule 14a-9 applies to proxy voting advice, such advice may not contain materially false or misleading statements or omit material facts that would be required to make the advice not misleading. This prohibition covers "information underlying the basis of its advice or which would affect its analysis and judgments, that would be required to make the advice not misleading."

The Proxy Voting Advice Guidance provided three examples of types of information that a proxy advisory firm may need to disclose to avoid a potential violation of Rule 14a-9:

- An explanation of the methodology used to formulate its voting advice on a particular matter (including any material deviations from the provider's publicly-announced guidelines, policies, or standard methodologies for analyzing such matters) where the omission of such information would render the voting advice materially false or misleading
- To the extent that the proxy voting advice is based on information other than the registrant's public disclosures, such as third-party information sources, disclosure about these information sources and the extent to which the information from these sources differs from the public disclosures provided by the registrant if such differences are material and the failure to disclose the differences would render the voting advice false or misleading–and–
- Disclosure about material conflicts of interest that arise in connection with providing the proxy voting advice in reasonably sufficient detail so that the client can assess the relevance of those conflicts

Investment Adviser Guidance

The Investment Adviser Guidance began with the following basic principles:

- Investment advisers are fiduciaries that owe each of their clients duties of care and loyalty with respect to services undertaken on the client's behalf, including proxy voting.
- In the context of voting, the specific obligations that flow from the investment adviser's fiduciary duty depend on the scope of voting authority assumed by the adviser.
- To satisfy its fiduciary duty in making any voting determination, the investment adviser must make the determination in the best interest of the client and must not place the investment adviser's own interests ahead of the interests of the client.
- Where an investment adviser has assumed the authority to vote on behalf of its client, the investment adviser, among other things, must have a reasonable understanding of the client's objectives and must make voting determinations that are in the best interest of the client.

According to the Investment Adviser Guidance, if an investment adviser does accept voting authority, it may agree with its client, subject to full and fair disclosure and informed consent, on the scope of voting arrangements. As examples, this guidance noted that the adviser and its clients could agree on exercising voting authority based on specific parameters, opportunity costs, type of proposal, or cost benefit considerations. However, when an investment adviser assumes proxy voting authority, even if limited in scope, it must make voting determinations consistent with its fiduciary duty and in compliance with the Proxy Voting Rule.

The Investment Adviser Guidance discussed the steps that an investment adviser that has assumed proxy voting authority could take to demonstrate that it is making voting determinations in a client's best interest, in two discrete circumstances. First, when an investment adviser has multiple clients, the adviser should consider whether voting the same way for all clients in accordance with a uniform voting policy would be in each client's best interest or whether it should have different voting policies for some or all of these clients depending on the investment strategy and objectives of each. Second, an adviser should consider whether certain matters, such as corporate events or contested director elections, may necessitate that the adviser conduct a more detailed analysis than what may be entailed by application of its general voting guidelines in order to consider factors particular to the issuer or the voting matter.

In addition, according to the SEC, an adviser should consider reasonable measures to determine that it is conducting its proxy voting activities in accordance with its voting policies. The SEC suggested that the adviser could sample its proxy votes (particularly those that may require a more detailed analysis as noted above) as part of its annual compliance review. The SEC believes that an adviser that retains a proxy advisory firm should consider additional steps to evaluate whether the adviser's votes were cast in a manner consistent with its proxy voting policies and in the best interests of the adviser's clients.

The SEC indicated that when an investment adviser is considering hiring or continuing a relationship with a proxy advisory firm for research or voting recommendations, the investment adviser should consider (among other things): the proxy advisory firm's capacity and competency to provide the requested services, including the adequacy and quality of staffing, personnel and technology; the proxy advisory firm's process for seeking timely input from issuers, clients and third parties regarding the firm's proxy voting policies; the firm's proxy voting methodologies (such that the investment adviser can understand the factors underlying the proxy advisory firm's voting recommendations); and the firm's peer group construction (e.g., how the firm takes into account unique characteristics of the issuer), including for "say-on-pay" votes. In addition, the SEC believes that the adviser's due diligence should include a reasonable review of the proxy advisory firm's policies regarding conflicts of interest.

In the Investment Adviser Guidance, the SEC stated that an adviser's policies and procedures should be reasonably designed to ensure that its voting determinations are not based on materially inaccurate or incomplete information. To that end, the SEC believes that an adviser that has retained a proxy advisory firm for research or voting recommendations should consider including in its policies and procedures a periodic review of the adviser's ongoing use of the proxy advisory firm. The SEC recommended that advisers also consider the effectiveness of the proxy advisory firm's policies and procedures for obtaining current and accurate information.

The SEC indicated that an investment adviser that has retained a proxy advisory firm to assist substantively with its proxy voting responsibilities should adopt and implement policies and procedures that are reasonably designed to sufficiently evaluate the firm, in order to ensure that the investment adviser casts votes in the best interest of its clients. The SEC believes that the investment adviser should consider requiring the proxy advisory firm to update the investment adviser about business changes that the adviser considers relevant (i.e., with respect to the proxy advisory firm's capacity and competency to provide independent proxy voting advice or carry out voting instructions).

The SEC stated that an adviser need not exercise every voting opportunity on behalf of a client in two situations. First, if the adviser and its client have agreed in advance to limit the conditions under which the adviser would exercise voting authority, the investment adviser need not cast a vote on behalf of the client where contemplated by their agreement. Second, there may be times when an investment adviser that has voting authority may refrain from voting a proxy on behalf of a client, e.g., where the adviser determines that the cost to the client (i.e., not the cost to the adviser) of voting the proxy exceeds the expected benefit to the client. The SEC cautioned, however, that in making such a determination, the adviser may not ignore or be negligent in fulfilling the obligation it has assumed to vote client proxies and cannot fulfill its fiduciary responsibilities to its clients by merely refraining from voting the proxies.

Next Steps

By issuing proxy voting guidance approved at the commission level (as opposed to staff guidance), the SEC has made a strong statement that it considers voting a significant

attribute of share ownership and shareholder engagement and an important consideration for investment advisers that have accepted proxy voting responsibilities. Proxy advisory firms, investment advisers, public companies and other parties involved in the proxy voting process should review the guidance carefully and consider seriously the advice it offers.

Because the Proxy Voting Advice Guidance discusses prior SEC interpretations and case law regarding what constitutes a solicitation, it is a resource for anyone interested in an analysis of what constitutes solicitation.

Looking Ahead

Both the Proxy Voting Advice Guidance and the Investment Adviser Guidance will apply to the upcoming proxy season. Therefore, proxy advisory firms and investment advisers should immediately begin assessment of what impact the SEC's guidance, examples, suggestions and interpretations will have on their proxy voting activities. And, because the guidance may affect proxy voting at annual meetings, public companies should monitor developments in this area.

In addition to considering the steps suggested in the Investment Adviser Guidance overall, registered investment advisers should review the guidance carefully and modify their practices, procedures and disclosures as appropriate, and should do so in advance of the upcoming proxy season.

Although the Investment Adviser Guidance was intended solely for registered investment advisers, advisers that are exempt from registration also might want to consider the guidance carefully, particularly given the numerous references to fiduciary duty, to which all investment advisers are subject.

The SEC expects to propose rules to amend the submission and resubmission thresholds for shareholder proposals under Rule 14a-8 and to propose amendments to address proxy advisory firms' reliance on the proxy solicitation exemptions in Rule 14a-2(b). Those interested in the proxy process should watch for these SEC proxy-related proposals.

Laura D. Richman, Counsel, Mayer Brown LLP

Laura Richman's wide-ranging corporate and securities practice has a strong focus on corporate governance issues and public disclosure obligations. Laura's practice includes Securities and Exchange Commission reports, such as proxy statements and annual, quarterly and current reports. She advises on executive compensation disclosure, insider trading regulation and Dodd-Frank and Sarbanes-Oxley compliance. Laura represents listed company clients with respect to stock exchange compliance matters. She advises clients on governance policies and other board and shareholder matters. In addition, her practice includes representing clients on transactions such as securities offerings and mergers and acquisitions, as well as providing general securities, corporate, limited liability company and contract advice. Laura has practiced with Mayer Brown since 1981.

With regard to securities transactions, Laura represents issuers and underwriters in public and private offerings of debt and equity securities (both initial public offerings and offerings of seasoned, public companies), including guidance on federal and state securities law compliance. She also advises issuers in connection with the securities law aspects of employee benefit plans and dividend reinvestment plans.

Other transactional matters in which Laura represents corporate clients include acquisitions and dispositions of assets or stock, restructurings (such as holding company formation) and going-private transactions. She also advises investors in leveraged buyout transactions, and represents financial institutions that take equity positions in companies. Laura advises clients on shareholder rights plans and anti-takeover protection provisions.

In addition to her governance and transactional practice, Laura counsels clients on day-to-day corporate questions. She drafts and reviews contracts and other corporate documentation, prepares terms and conditions of sale, provides guidance on limited liability company and other limited liability entity issues, and assists clients with various regulatory issues. Laura was named an Illinois Super Lawyer for Business/Corporate in 2006 and 2008.

Leslie S. Cruz, Counsel, Mayer Brown LLP

Leslie Cruz serves as counsel in the Washington DC office and is a member of Mayer Brown's Corporate & Securities practice. Leslie focuses her practice on representing registered investment companies, investment advisers, and other financial institutions engaged in market, financial or investment management activities. She assists clients with a wide variety of matters, including the formation, registration, reorganization, merger, acquisition and liquidation of investment companies and investment advisers, and ongoing assistance with investment management regulatory and business matters. Her investment company representations have included mutual funds, exchange-traded funds, funds of funds, multi-managed funds, multi-series funds, multi-class funds and closed-end funds. Her investment adviser representations have included managers of managers, sub-advisers, real estate advisers, model portfolio advisers, wrap fee sponsors and participants, mutual fund allocation program advisers, private fund advisers and registered fund advisers.

Leslie assists clients with: exemptive applications, "no-action" letters, investment company registration statements and other regulatory filings, investment adviser registration forms and other regulatory filings, compliance procedures, corporate documents, service agreements (advisory, sub-advisory, fund accounting, administrative services, transfer agency services, distribution and others), and other regulatory and business filings and documents. She also provides guidance regarding domestic and foreign custody practices, personal trading and codes of ethics, investment company and investment adviser advertising (including website and Internet usage), social media practices, intellectual property licensing arrangements and related disclosures, securities lending arrangements, liquidity determinations and practices, trade and net asset value error correction practices, pricing and fair valuation policies, practices and operations, anti-money laundering compliance, privacy practices, and corporate governance issues affecting investment companies and investment advisers.

Leslie's practice also includes assisting clients with: investment company and investment adviser status analyses and opinions (including with respect to specific offerings or other transactions), Rule 2a-7 product analysis, revenue-sharing arrangements and various types of mutual fund intermediary agreements (e.g., administrative services, "sub-TA", dealer/sub-distribution and shareholder servicing), prospectus delivery practices and procedures, SEC examinations and inquiries, "mock" examinations, targeted compliance and business practice reviews, internal investigations, due diligence reviews for various purposes (including review of potential business transactions and partners); affiliated transactions analysis; independent director status and analysis; corporate governance structures, practices and procedures (including board committee and classified board formations and operations), sub-adviser oversight practices, credit facilities and transactions, repurchase agreement facilities and transactions, derivatives and leveraged transactions, complex regulatory disclosures, investment company related bank regulatory matters, portfolio manager lift-outs, and spin-outs.

Leslie brings a thorough understanding and appreciation of the regulatory and market environments to counseling clients, and has a keen interest in new product development for investment companies and investment advisers.

Adam D. Kanter, Partner, Mayer Brown LLP

Adam Kanter is a partner in the Corporate & Securities practice of the Washington office. He focuses his practice on counseling domestic and non-US investment advisers, investment companies, and other financial services firms on a variety of regulatory, compliance, enforcement, and transactional matters.

Adam has advised clients on a wide range of investment management matters, including formation, registration, and ongoing compliance issues of investment companies and investment advisers. He has also assisted clients in adapting to new regulations, such as the custody rule and pay to play rule under the Investment Advisers Act of 1940, and the amended money market fund rule under the Investment Company Act of 1940. Adam also advises clients on related matters, including the preparation of registration statements, compliance policies and procedures, proxy statements, "no-action" letter requests, exemptive applications, comment letters, and corporate documents.

Recently, Adam has been involved in advising a variety of financial services clients on implications of the "Dodd-Frank Wall Street Reform and Consumer Protection Act," particularly with respect to its effects on entities with cross-border operations. He joined Mayer Brown in 2008.